- **The massive excess capacity within the Telecom industry was the result of four contributing dynamics.**

Excessive hype related to insatiable bandwidth requirements fueled network expansion by both existing carriers and new entrants

Internet "Explosion" ↓

Wireline and data competition policies and rules fueled unprecedented capital spending based on unsustainable underlying economics.

Technological Competition → **Telecommunications Industry** ← **Telecom Act Implementation**

↑ **Economic Downturn**

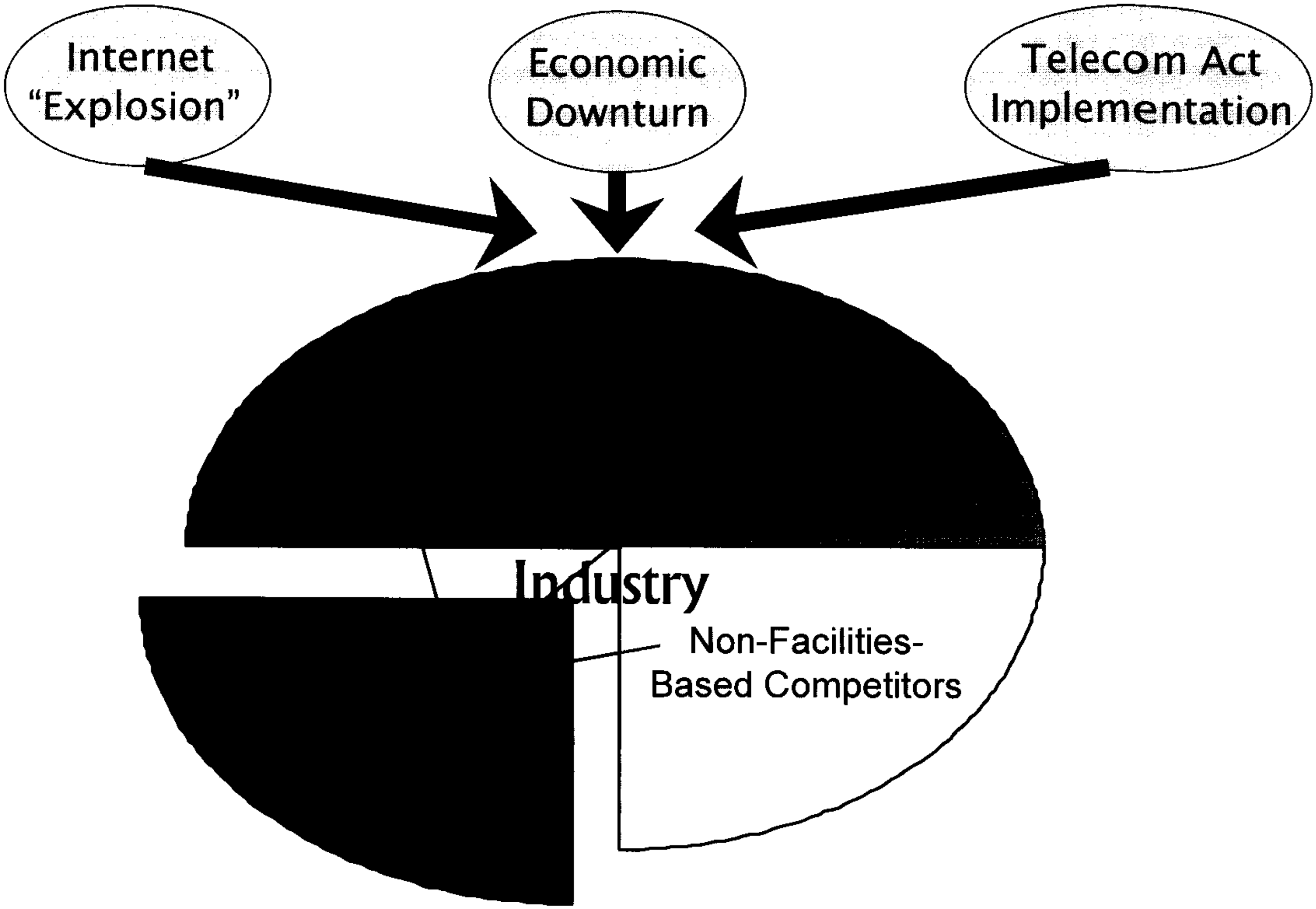
Wireless competition, driven by free-LD / free-roaming, bulk minute plans, eroded access lines in service, switched access and toll revenues with very little reduction in ongoing costs.

Broadband substitution, both DSL and cable modem, rapidly eroded second access lines in service market.

Increases in business bankruptcies (and net bad debt) accompanied by a dramatic decline in demand for data services exacerbated the industry over-build situation and further undermined the industry's economics.

What Happened?

- The massive excess capacity within the Telecom industry was the result of three contributing dynamics all of which put tremendous financial pressure on the ILECs.



Proposed Regulatory Solutions

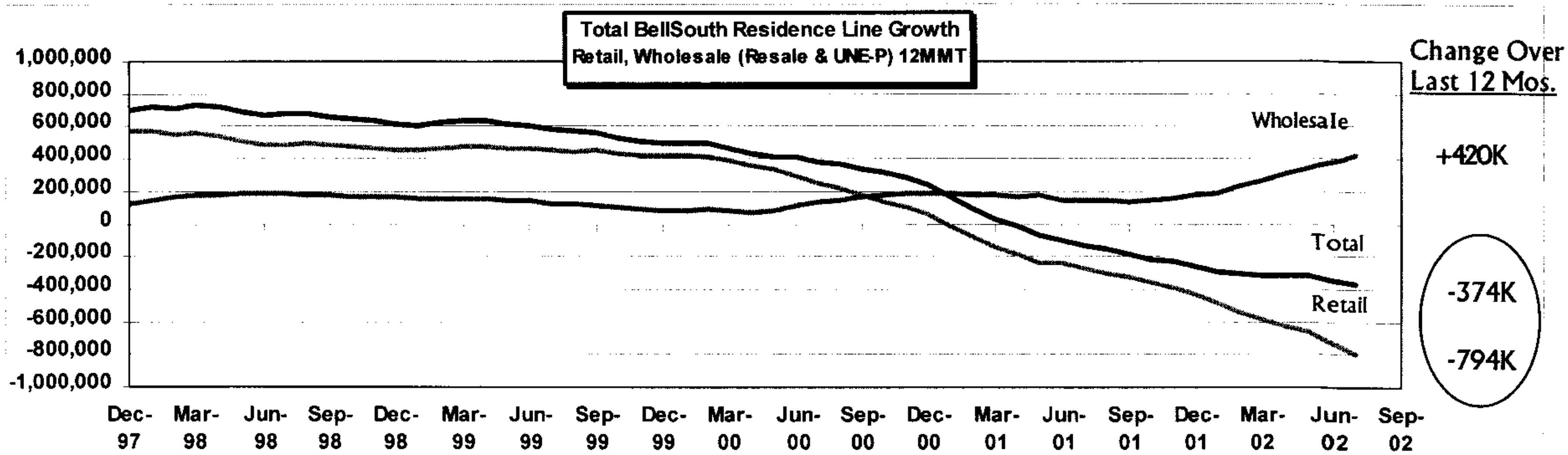
➢ **It is imperative that immediate changes be made to the regulatory framework to stabilize the telecom industry.**

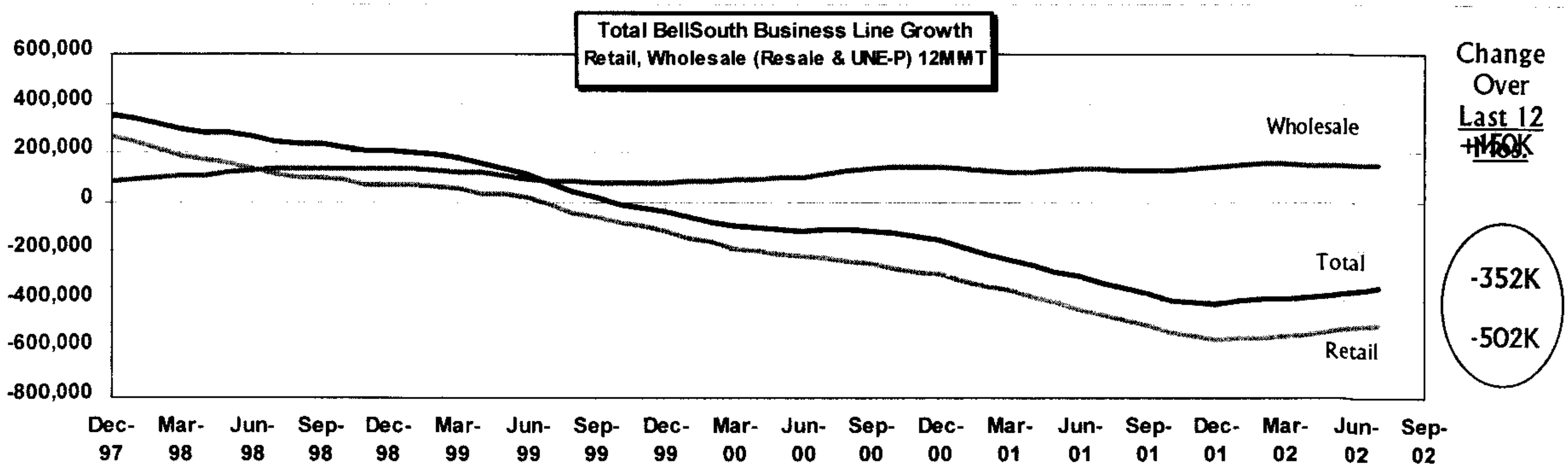
Unrestrained Entry	▪ Certify financial integrity and business models of new entrants ▪ Require investment in facilities within some specified timeframe
Shortcomings in UNE Rules	▪ Move toward class-of-service-specific and market-based rates ▪ Impose sunset limits on UNE-P ▪ Restrict UNE-P to non-competitive areas ▪ Continue safe-harbor local service restrictions ▪ Require CLEC to submit to ILEC audits as allowed by regulations. Introduce penalties to discourage representation of facilities as local in order to circumvent use restrictions#
Cumbersome Operating Requirements	▪ Move to Bill-and-Keep with respect to Interconnection ▪ Restructure collocation rates to allow for greater up-front recovery of ILEC investment ▪ Limit the number of elements that are required to be unbundled ▪ Eliminate or "grandfather" elements that have zero or insignificant demand
Inequitable and Dual Standards	▪ Address ILEC and CATV open facilities access in a uniform manner ▪ Do not require unbundling of advanced services ▪ Adjust UNE rates to reflect residential/rural subsidies ▪ Allow ILECs pricing flexibility to align residential rates more closely with cost ▪ Simplify and standardize service measurement requirements ▪ Establish uniform LEC standards for customer transfers ▪ Establish procedures for disconnecting service to CLECs in prolonged non-payment situations

14 of 15 CLECs objected to an audit by BellSouth. The matter has been escalated to the FCC.

Current State of BellSouth's Wireline Business – Competition

➢ **Access line losses in the Residential market have been driven by both wireline and wireless competition. Recent increased focus by AT&T and MCI on the Residential market in our top metros is evident. Competitive access line loss in the Business market has also been substantial.**





Current State of BellSouth's Wireline Business – Cost Structure

- **Although regulatory frameworks have changed, the economics of managing a labor- and capital-intensive business, such as Telecom service, have not changed over the last 120 years . . .**

Telecom Service "Network Economics"

Nature of the Business

High Labor Intensity
(Internal and external labor costs represent 44% percent of Operating Expense.)

High Capital Intensity
(ILECs deploy xx% more capital per dollar of revenue than the S&P 400)

Focus

Maximize Labor Efficiency

Maximize Scale
(Ubiquitous Investment, High Utilization)

=

Objective

Maximize Profitability Per Dollar of Investment

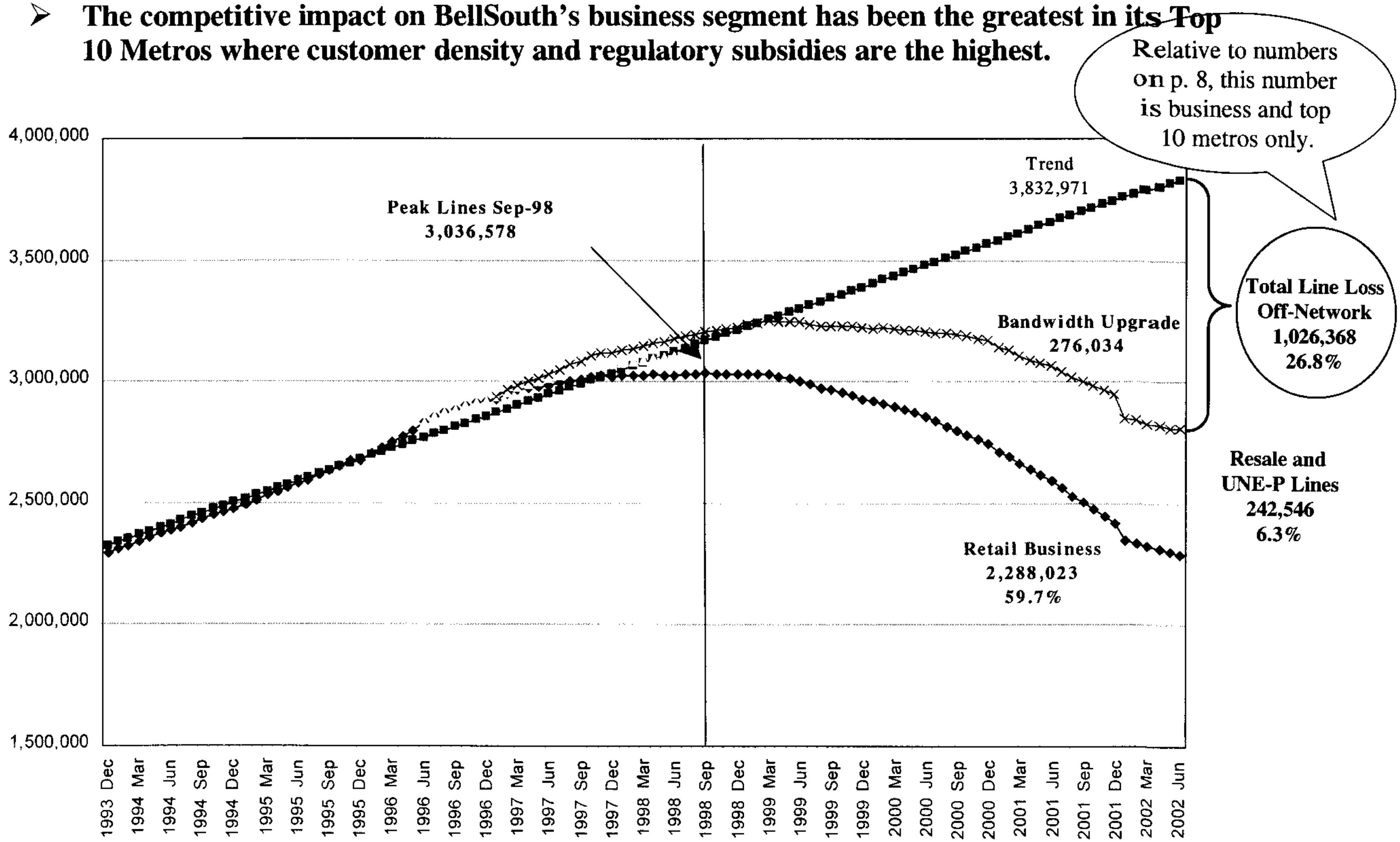
. . . in the end, the fundamental of issue in most CLEC failures related to the inability to manage these "network economics."

Equity Issues Related to the Regulatory Treatment of ILECS vs. CATV

Regulatory Requirement	Applies to local phone co. DSL?	Applies to Cable?	Applies to Satellite?	Applies to Fixed Wireless ?
Common carrier duty to provide service at just and reasonable prices	Yes	No	No	No
Common carrier duty prohibiting discriminatory treatment	Yes	No	No	No
Duty to provide network to internet service providers	Yes	No	No	No
Duty to file tariffs	Yes	No	No	No
Duty to follow detailed system of regulatory accounting	Yes	No	No	No
Depreciation charges set by regulators	Yes	No	No	No
Duty to interconnect with competitors at below cost prices	Yes	No	No	No
Duty to resell services at government-set discounts	Yes	No	No	No
Duty to negotiate with competitors for access to network	Yes	No	No	No
Duty to provide competitors with piece parts of the network at below cost prices – piece parts such as • connections to the house or business for high speed Internet access • transport for high speed Internet access • computer systems for ordering service	Yes	No	No	No
Duty to allow competitors to locate their equipment at company premises at below cost prices	Yes	No	No	No
Duty to provide dialing parity	Yes	No	No	No
Duty to pay reciprocal compensation	Yes	No	No	No
Duty to provide subscriber list information	Yes	No	No	No
Duty to provide number portability	Yes	No	No	No
Government approval needed to provide long distance voice service	Yes	No	No	No
Requirement to provide equal access to long distance providers	Yes	No	No	No
Government approval needed to provide long distance Internet service	Yes	No	No	No
Duty provide long distance service only through a separate corporate subsidiary	Yes	No	No	No
Duty to support universal service	Yes	No	No	No

Current State of BellSouth's Wireline Business – Competition

- **The competitive impact on BellSouth's business segment has been the greatest in its Top 10 Metros where customer density and regulatory subsidies are the highest.**



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Telecom Act Implementation: Unrestrained Entry (and Re-Entry)

- **Unrestrained entry into the Telecom industry has fueled over-capacity, increased industry costs (including net bad debt and churn), and undermined the business models of all facilities-based competitors.**

Make what is underlined points on slide. Move rest to notes

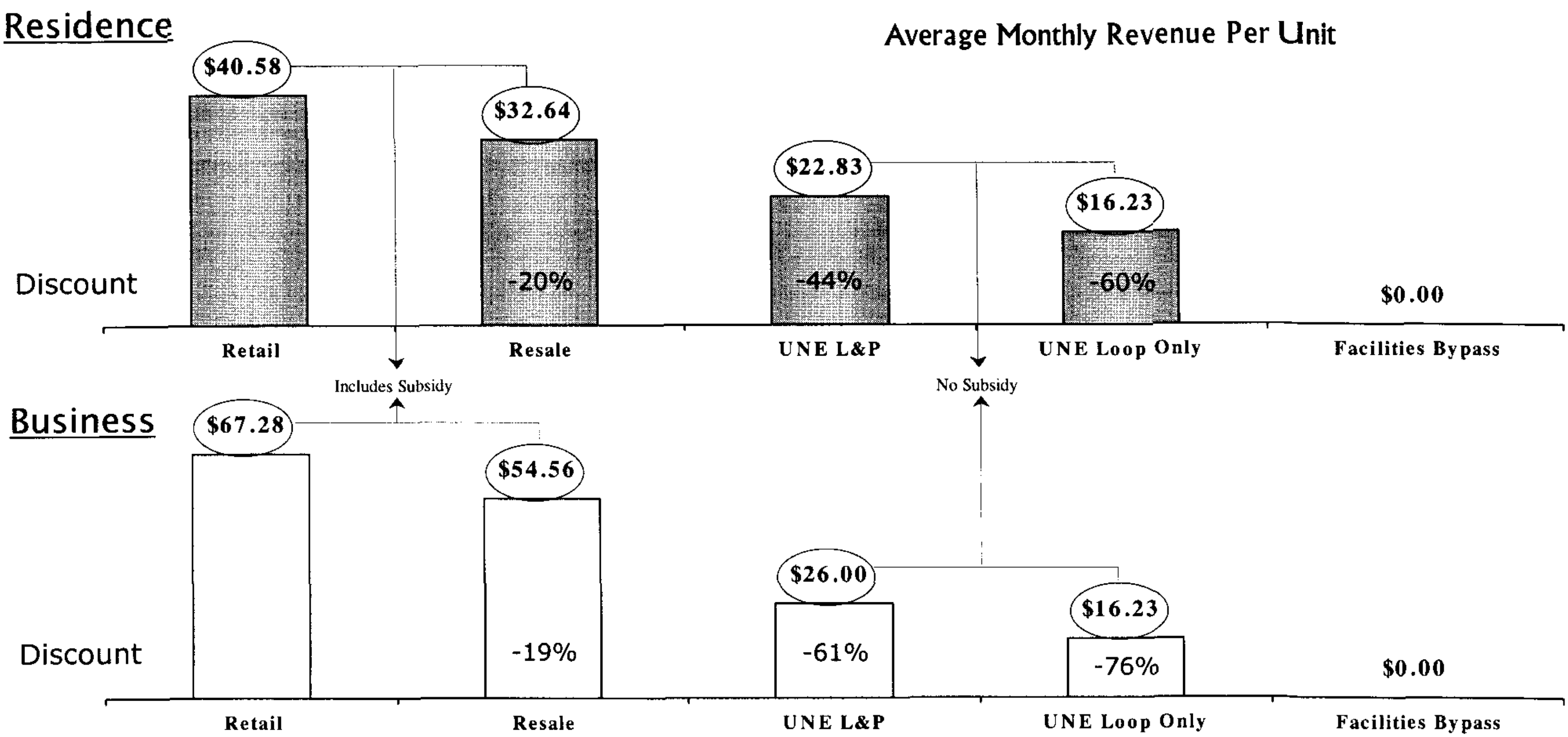
- Unrestrained entry has led to **a glut of uneconomic CLECs**, many with unsound business models. Some CLECs were initially designed to exploit unsustainable arbitrage opportunities (principally reciprocal compensation arrangements) within the Act. Many are now created for the sole purpose of exploiting UNE-P with no intent to deploy facilities and no meaningful capital at risk.

- The immense number of players has **increased industry costs** including operating support systems requirements, interconnection facilities, and costs associated with customer churn between carriers. In addition, the high number of bankruptcies has increased industry net bad debt (due to the interconnectedness and interdependence of the industry) and increased the costs of capital to the industry.

- In the end, unrestricted industry access has **disadvantaged all facility-based competitors. First came over-capacity financed with high debt levels. Then came non-facility-based competition which further pressured network economics leading to a high rate of business failures (bankruptcies). Resulting in a growing portion of the industry with over-capacity and light debt loads. Which will put further pressure on the rest of the industry.**

Telecom Act Implementation: Uneconomic Competitive Rules

- **... the embedded subsidies are even more evident when you look at the total revenue per per access line ...**



. . . placing ILECs at a significant competitive disadvantage in that they bear the entire framework of subsidies built into their rates (where margins are richer in business than residence, and in urban than rural), allowing CLECs to cream-skim the highest value customers . . .

Telecom Act Implementation: Uneconomic Competitive Rules

- **. . . Most importantly, UNE prices (predicated on the theoretical costs to build and maintain a theoretical network that will never exist) have resulted in pricing to ILEC competitors below actual costs . . .**

Georgia - Business	Retail	UNE-P		% Change
Revenue				
Basic Service	$ 52.85	$ 21.91		
Features & Other Services	$ 11.25	-		
SW A / LIC	$ 4.10	$ 0.09		
Total Revenue	**$ 68.20**	**$ 22.00**		**-68%**
Expense				
Customer Care	$ 3.26	$ 4.37	[1]	
Line Maintenance	$ 3.51	$ 3.51		
Asset-Related	$ 6.12	$ 6.12		
Uncollectibles	$ 0.57	$ 0.64	[2]	
Total Expense	**$ 13.46**	**$ 14.64**		**9%**
Product Contribution	**$ 54.74**	**$ 7.36**		**-87%**
Non-Product-Specific Shared Costs	**$ 9.29**	**$ 9.29**		**-**
Pretax Margin	**$ 45.45**	**$ (1.93)**		**-104%**

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[1] Retail per unit costs lower due to scale and absence of unique customer interface arrangments.

[2] Wholesale uncollectibles expense has been approximately three times the Retail level due to business failures as a percent of revenue.

Source: BellSouth Activity-Based Accounting System

. . . The financial burden on the ILECs associated with UNE-P pricing is magnified since UNE-P lines actually carry higher costs than Retail lines. This combination literally bleeds the profitability out of the ILECs.

Telecom Act Implementation: Inequitable and Dual Standards

- **The list of Inequitable and Dual Regulation Standards that exists between ILECs and their competitors is lengthy but all share the commonality of disadvantaging the ILEC competitive position.**

  - The inequities in ILEC regulatory treatment relative to its CATV competitors are extensive (see page 37) and particularly serious since CATV companies continue to mount one of the strongest offensives.

    - » The FCC has **imposed line-sharing and resale obligation** on the ILECs related to DSL, while CATV companies are not required to open their networks to ISPs.

    - » The FCC has imposed **USF payment requirements** on wholesale DSL while requiring no such contributions from cable modem. In the second quarter of 2002, BellSouth's payments in this regard totaled $7 million.

    - » In light of the potential application of the UNE pricing standard, it is not surprising that uncertainty around likely regulatory treatment of new products has provided an innovation disincentive to the ILECs.

Telecom Act Implementation: Inequitable and Dual Standards (Continued)

- The ILECs are held to different service standards than their CLEC competitors as well.

  » Services standards, imposed with good intentions (i.e., to ensure that ILECs provided services to CLECs at parity with the level provided to their Retail customers), are ever-changing and excessive in number. BellSouth reports over 2,300 unique measurements each month, some at a state- and/or CLEC-specific level.

  » In addition to paying $42 million in penalties during 2001, BellSouth spent another $135 million building systems to track measurements and to conduct third-party testing. CLECs are not subject to similar penalties - even if the *ILEC* service "miss" was caused by *CLEC* action.

  » ILECs are also required to open up their OSS to facilitate the movement of its customers to CLECs, but no reciprocal arrangements are required of the CLECs for either ILEC "reacquisitions" or CLEC-to-CLEC moves.

  » ILECs are required to bear the cost recovery risk associated with provision of collocation facilities ordered by CLECs. Massive over-ordering during the Internet boom resulted in large amounts of expenditures (over $250 million by BellSouth), followed by subsequent disconnects, bankruptcies and abandonments. *(57% of BellSouth's Collocation accounts receivable were over 90 days past due on 03/31/02.)*

Telecom Act Implementation: Inequitable and Dual Standards (Continued)

- Finally, the ILECs continue to be hobbled by State PSC requirements to subsidize residence and rural services.

  » In contrast, the CLECs are allowed to cream-skim customers in areas where subsidies are the highest using ILEC facilities at below-cost UNE rates.

  » As shown previously, this situation is bleeding the very ILEC margins that allow the desired subsidies and cannot persist over time.